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Development Banking – Way Forward

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Respected Professor Madiah garu, Mr. Nirmal Mohanty, Dr. Sudheer garu, distinguished participants and Friends,

I am grateful to the Indian Economic Association and National Stock Exchange of India for inviting me to deliver a Special Lecture, the NSE-IEA Lecture on Financial Economics. I have pleasant memories of my association with both IEA and NSE. This is a significant Conference since it happens to be the centenary celebration of the Indian Economic Association. My association with the IEA is half a century old. I have pleasant memories of working on the establishment of National Stock Exchange (when I was in the Ministry of Finance) in early 1990, along with Dr. R.H. Patil (then with IDBI, the most leading development Bank in India).

I chose the subject Development Banking for the lecture today because there is a revival of interest in development banking consequent upon the large amount of non-performing assets in the banking sector in India. It is believed that large part of NPAs, are on account of banks' exposure to the infrastructure sector. It is now felt in some quarters that the universal banks are not the ideal institutions for development of infrastructure. There is, therefore, interest in resurrecting Development Banks.

The Reserve Bank of India has circulated a discussion paper recently on Wholesale and Long-Term Finance (WLTF) banks. The discussion paper recognises the current problems faced by banking sector in long-term and project finance, in particular, infrastructure projects and also reflects the change in attitude of the RBI in regard to differentiated banks.

WLTF: A proposal

It is useful to recall the background of the proposal for WLTF. In the monetary policy statement of 2007-08, RBI proposed consideration of licensing differentiated banks – which could open up possibilities of a category of banks devoted to long term investments. At that time, international experience and procedures were studied. Some regulators issued universal banking licences only and others issued limited banking licences also. Limited banking Licence may be applicable equally for domestic and foreign banks, or differently for them. There were countries where different licences were issued for commercial banking, savings bank, credit unions, etc. There was no widely accepted recommended model internationally. Therefore, the technical paper on Differentiated Banks Licences concluded its recommendations (October 19, 2007) in the following words:

"It may be seen that one of the major objectives of banking sector reforms has been to enhance the efficiency and productivity of the banking system through competition. It is also aim of authorities to provide banking services to maximum number of people. To enable the banking system to operate at optimum efficiency, and in the interest of financial inclusion, it is necessary that all banks should offer certain minimum services to all customers, while they may be allowed sufficient freedom to function according to their own business models. Thus, it will be prudent to continue the existing system for the time being. The situation may be reviewed after a certain degree of success in financial inclusion is achieved and Reserve Bank is more satisfied with the quality and robustness of the risk management systems of the entire banking sector."

In any case, no new licences were considered by RBI till the Act was amended to strengthen the RBI's powers to ensure fit and proper ownership and good governance. Consequent upon legislation on this and a Discussion Paper on New Licences in 2010, guidelines were issued in 2013. The policy of differentiated Licences came into existence later with in principle approvals for payments banks and small finance banks in August / September 2015.

In April 2016, the Monetary Policy Statement stated that in addition to the recently licenced differentiated banks, RBI will explore possibilities of other differentiated banks as well. RBI brought out a Discussion Paper on Wholesale and Long-term Finance Banks (WLTF).

The Discussion Paper inter alia recalls that the Financial Stability Report of the Reserve Bank of India, issued in December 2015, stated that "in view of the riskiness on account of the tenor of the loan, the banks' current processes and business models may not yet be adequately prepared to make, monitor and manage long-term project loans. In that context, it is felt that differentiated banks, with focus towards long-term and project finance, could possibly be able to quickly build / leverage expertise, in terms of people, processes, and systems, to develop sophisticated methods of credit appraisal and credit enhancement to fulfill the financing needs of the infrastructure sector."

The discussion paper, therefore, proposes WLTF banks as a set in differentiated banks. WLTFs are expected to be very large institutions *ab initio* to take on large exposure to industrial, commercial and infrastructure sector. Further, they are expected to carry substantial credit-concentration and devise sophisticated financial products. A higher level of initial minimum paid-up equity capital, say Rs.1,000 crores or more is suggested for these banks, while eligibility of promoters will be same for universal banks.

WLTF are envisaged to provide financial services predominantly in the wholesale segment of the market. WLTF banks' focus would be on lending long-term to cater to the funding needs of certain sectors of the economy which create assets with long gestation period such as infrastructure and core industries.

Sources of funds for WLTF banks will include issuance of bonds, commercial bank borrowing, certificate of deposits, securitization of assets etc. WLTF banks are not expected to accept savings deposits. Current Account and Term Deposits may be mobilized by these banks. A higher threshold for term deposits, say above Rs.10 crore, might be considered.

Relaxations in respect of CRR, SLR, and prudential norms on liquidity risk and compliance with liquidity ratios such as Liquidity Coverage Ratio / Net Stable Funding Ratio may be considered for WLTF banks. Opening of rural and semi-urban branches and compliance to priority sector lending norms would not be mandated for WLTF banks.

The discussion paper concludes with a set of issues for discussion which reads as follows: Whether there is a need for a separate class of wholesale and long-term financing bank and whether the time is opportune for the same? Whether they would have a viable business model considering the limited avenues for raising long-term resources and significant mismatches on their asset-liability profile? Whether the proposed regulatory framework is appropriate?

There were several reactions to the paper, but among them a paper by Dr. Nagaraj is noteworthy, and extracts are revealing since they represent main-stream thinking of those in favour of Development Banking.

"The RBI's 'Discussion Paper on Whole-sale and Long-term Finance Banks' is a welcome initiative, as the concept seems similar to Development Banks. Perhaps the proximate reason for the initiative is the poor domestic investment climate, as commercial banks are saddled with mounting NPAs caused by lending for private corporate infrastructure investment during the boom years." While the NPAs were caused by post-global financial crisis or boom years is debatable, the provocation for the proposal is the performance of commercial banks, especially public sector banks.

Dr. Nagaraj continues: *"The critical requirements for the success of Development Banks are: (i) secure sources of low-cost, long-term funds; (ii) public ownership and/or management; and (iii) quality of institutional governance. The sources of funding for Development Banks vary across countries, but their underlying* *principles and their overarching objectives have remained the same. Development Banks necessarily incur quasi-fiscal costs, and they are mostly kept off-budget to insulate their investments from budgetary bargaining."* The Discussion Paper seems to favour special regulatory regime to enable low cost, long term funding and quasi-fiscal, if not, fiscal costs.

Dr. Nagaraj adds: *"However, the critical challenge in reimagining Development Banks would be to avoid past mistakes, and have built-in checks and balances in its governance structure to safeguard managerial independence without compromising on the need for periodic, independent public scrutiny."*

Dr. Nagaraj explains: *"Reimagining Development Banks would, however, have to contend with the earlier criticisms of misallocation of resources and poor accountability due to political and bureaucratic meddling, as was evident from rising NPAs and industrial sickness, giving rise to the popular quip: "Industries (or firms) get sick, but industrialists prosper!" The recent corruption scandal that has engulfed Brazil's BNDES – the world's largest development bank – is a cautionary tale in this respect (Leaty 2015). There seems to be no getting away from the governance issues that often bedevil such an institution."*

The interesting issue is: if governance is the main issue, why not address it through the existing large public sector banks?

More fundamental question is whether concept of WLTF is similar to development bank?

In brief, there is need for clarity on the concepts of Development Banks and WLTF.

<u>What is a Development Bank</u>?

A World Bank survey defines a development bank as "a bank or financial institution with at least 30 per cent State-owned equity that has been given an explicit legal mandate to reach socioeconomic goals in a region, sector or particular market segment".

According to UNCTAD, Development Banks are needed to bridge finance from end-savers to development projects. Such bridging should be done by Development Banks at all levels – national, regional and international – in order to provide the financing needed in the developing world. Development Banks can thus be key players for development by providing long-term financing directly from their own funding sources, by tapping into new sources and by leveraging additional resources, including private, through the co-financing of projects with other partners.

In brief, Development Financial Institutions also designated as Development Banks are often equated with the institutions which supply capital, knowledge, and enterprise, in an integrated manner as the three major ingredients of development for business enterprises. These institutions are meant to provide long term finance to agriculture, industries, trade, transport and basic infrastructure.

It is interesting that in the discussions on development banking, no distinction is made between bank and non-bank development finance institution. In brief, Development Bank is a somewhat nebulous concept with common features: Public ownership, at least in part; development orientation in financing; concessional or quasi-fiscal costs; and not entirely market led activities.

The Global Experience

Financial institutions that have supported a big industrialization push in the past, pre-date the Development Banks that were created in developing countries after the Second World War. In Europe, late industrializers in the nineteenth century, such as France and Germany, benefited from institutions that provided not only capital but also entrepreneurial skills and technological expertise. The publicly owned Kreditanstalt für Wiederaufbau (KfW) in Germany was established in November 1948 to support the reconstruction of the country. KfW evolved as a component of long-term financing for infrastructure, a promotional bank for the German economy and a development bank for developing countries. Historically in Japan, post office savings by households was the principal source of low-cost funds for the Development Bank of Japan.

During 1950s and 60s, in countries such as Argentina, Brazil, Chile, China, Egypt, Indonesia, South Korea, Malaysia, Mexico, Taiwan, Thailand and Turkey, DFIs were set up specifically to provide long-term financing for investment in the industrial sector. China's historically unprecedented investment-led growth is known to have been propelled by three policy banks.

Most Development Banks in developing countries, including India, were promoted and financed by World Bank.

The Development Banks did not remain static, and they transformed over a period.

The Development Banks continue to have the twin objectives of fostering development and providing financing with close ties to State and less of a market-based institution. They are a diverse group in terms of ownership, funding structure and the types of projects and activities they specifically support.

A World Bank survey shows that 41 per cent of the surveyed institutions take deposits, 89 per cent borrow from other financial institutions or issue debt in local markets, 40 per cent receive budgetary transfers from the Government and, importantly, 64 per cent benefit from government guarantees on the debt they issue. The exact funding mix is important in determining their ability to pursue their socioeconomic goals. For example, half of the banks surveyed by the World Bank provide credit at subsidized interest rates and two thirds claim that financing for such subsidies comes from government transfers. In some cases, subsidy financing comes from cross-subsidization.

A common characteristic among the Development Banks has been their broad mandates, with engagement in a wide range of sectors and activities. Over the years, they have supported large infrastructure projects and the creation and expansion of heavy industries. More recently, they have refocused their strategies towards supporting innovation, small businesses and clean energy projects.

The Development Banks were not static. As private sector developed, the Development Banks transformed.

Singapore converted DBS into a commercial bank renamed as DBS Bank. In

2004, IFCT in Thailand was sold to the Thai Military Bank and absorbed into commercial banking. In Turkey, TSKB is now a privately-owned investment bank in which the largest Turkish commercial bank has a majority share.

However, Japan has followed a different model. The JDB was dissolved in 1999 after almost 50 years but replaced by the Development Bank of Japan (DBJ) with a new mandate to focus on regional development. In addition, the Japan Finance Corporation (JFC), wholly owned by the government, was established in 2008 following the merger of four policy-based financing institutions.

It is interesting that a report by London School of Economics in 2013 recommended the setting up of infrastructure banks to galvanise investments in infrastructure. To quote: "An Infrastructure Bank (IB) to facilitate the provision of stable, long-term, predictable, mostly private sector finance for infrastructure." Such a bank was expected to help "overcome key market failures in capital markets in a direct and constructive way. In particular, it can help to reduce policy risk and, through partnerships, to structure finance in a way that mitigates and shares risk efficiently. This will require a whole range of financial instruments including equity and structured guarantees."

While there are differing approaches to Development Banking, there is merit in learning from global experiences in a dynamic environment taking account of our own experience.

<u>Indian Experience with Development Banking</u>

In India the first phase of development banking was in the period 1948-1964. This phase had three components: long-term-lending institutions that were nationwide, institutions for the states, and what came to be described as investment institutions. These were Industrial Finance Corporation of India (1948), State financial corporations (1952), Industrial Credit and Investment Corporation of India (ICICI) (1955) with the support of the World Bank and the Government of the United States of America. The establishment of other specialized financial institutions followed, including the Agriculture Refinance Corporation, Rural Electrification Corporation and Housing and Urban Development Corporation and IDBI (1964). They were funded by bilateral and multilateral sources.

Between 1964 and the mid-90s further expansion took place with the setting up of National Bank for Agriculture and Rural Development and Export–Import Bank of India in 1982 and Small Industries Development Bank of India in 1990. The other sector-specific institutions include PFC, IRFC, and National Housing Bank.

The DFIs had till 1990s access to funds at concessional interest rates largely in the form of i) National Industrial Credit Long Term Operations (NIC-LTO) Fund, which was created out of the profits of the RBI and ii) bonds which were reckoned for computation of Statutory Liquidity Ratio (SLR).

The NABARD and the NHB exercise regulatory powers over rural cooperative system and Housing Companies, respectively. They had access to tax free bonds from time to time. NABARD had access to fund from banking system under Rural Infrastructure Development Fund.

Over the years, the two major development finance institutions have amalgamated with their banking outfits (such as ICICI and IDBI). Other DFIs have been reclassified as systemically important non-deposit taking NBFCs. The remaining four all-India financial institutions – Exim Bank, National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industrial Development Bank of India (SIDBI), which are primarily refinancing agencies, are under the oversight of the Reserve Bank.

As part of reform that commenced in 1990s, access to refinancing facility by RBI was discontinued. RBI took the view that its profits would henceforth be transferred to Government, which will decide the allocation of resources to competing demands. Access to Government funds continued and access to funds from RBI was replaced with financial markets.

After the commencement of reforms, several new Development Banks were promoted, of which IDFC (1997) and IIFCL (2006) are prominent, the former with predominant funding from Government and RBI but managed by private shareholders, and IIFCL (Indian Infrastructure Finance Company Ltd.) as a one hundred percent Government owned entity (2006).

Review of Experience in India

In 1950s and 1960s, Development Banks in India were designed at a time when private sector was not developed and financial sector was not developed. Their expertise helped develop financial market infrastructure institutions in our country. Some of them made profits.

With nationalisation of banks in 1969, most of the banking system as a whole came under public ownership and control. The Development Banks, especially refinancing institutions, operated mainly through the banks or State level Development institutions, or State government.

After reforms in 1990s, withdrawal of monopoly, license, control, import restrictions, tax concessions etc by Government and of concessional refinance by RBI resulted in pressure on margins of IDBI and ICICI. The assistance from World Bank Group was not forthcoming. It is also interesting to track the contrasting growth and contribution of IDBI and ICICI since their becoming universal banks.

Government confined fiscal support to some (For example, NABARD and SIDBI), though they are financially sound, and in fact make profits. However, farmers and small scale industry, whom they are meant to support, are under stress.

With creation of new Development Banks since 1990s (IDFC, IIFCL), despite exit of IDBI and ICICI, the total coverage of Development Banks has not diminished and, in fact, expanded.

Some Generalisations

A review of global and Indian experience enables us to make some generalisations.

Development Banks are useful depending on relative capacities of private sector, financial sector, and state / government sector. They require fiscal support, regulatory forbearance and sometimes special access to natural resources or monopoly. Sometimes such support may be justifiable. Benefit of better coordination is possible in them, but the downside is conflict of interests.

In theory, Development Banks do provide good opportunity to have a contextual mix of state and market, financial and real, global and national. They have institutional flexibility to combine official and private, domestic and international finance. In the evolving approach to Development Banking there is diversity of shareholders, multiplicity of interests and a variety of instruments, but all risks are with the government. The objectives, scope and role of Development Banks vary depending on stage of development of economy and of markets.

In respect of infrastructure funding, there is need for close interaction with public policy, and this is reflected in the working of Development Banks.

The governance issues are critical to success of Development Banks. To the extent they are extended arms of governments, the standards of governance in Development Banks may broadly reflect those in government.

In brief, for policy purpose, Development Banks are good if well designed and appropriate to circumstances of the country, with an element of flexibility to suit evolving circumstances.

Way Forward

The way forward in regard to development banking in India has to be considered in the light of a realistic assessment of the current situation – in particular the problems that we are trying to solve. It cannot be based on assumptions related to the relative strengths and weaknesses of State and Market in finance in India. It can certainly be based on the assessment of the prospective relative strengths and weaknesses. For this purpose, several questions need to be posed and addressed.

Is there a problem of inadequate finance from banking system that warrants a new Development Bank? According to Dr. Chakraborthy, then Deputy Governor: *"It is pertinent to note that outside of budgetary support that accounts for about 45 per cent of the total infrastructure spending, commercial banks are the second largest source of finance for infrastructure (about 24 per cent). Between March 2008 and 2013 alone, banks' exposure to infrastructure has grown by more than 3 times. This apart, credit has also flown into infrastructure sector via NBFCs, Mutual Funds and capital markets, the source of bulk of which is bank finance. It may not, therefore, be correct to argue that lack of finance from banks has constrained the development of the infrastructure sector."*

Is the current problem one relating to the design and implementation of infrastructure projects in India or, is it relating to the financing of such projects?

Is the problem one of incapacity of the banking system to make realistic project appraisal?

The answer seems to be both. Dr. Chakraborthy, then Deputy Governor said in his characteristic candid manner in 2013: *"The evidence, thus, clearly suggests* *that banks have been substantially financing infrastructure projects in the country notwithstanding the inadequate commercialization of projects due to regulatory, political and legal constraints and total absence or insufficiency of user charges in many sectors. Of course, this has not been without a fair share of pain for them. The NPAs and the restructured assets in this segment have increased quite substantially of late. The Gross NPAs and restructured standard advances for the infrastructure sector, together as a percentage of total advances to the sector, has increased considerably from Rs.121.90 bn (4.66%) as at the end of March 2009 to Rs.1369.70 bn (17.43%) as at the end of March 2013. There is enough evidence to suggest that a substantial portion of the rise in impaired assets in the sector is attributable to non-adherence to the basic appraisal standards by the banks."*

Is the problem with banks being universal banks or the problem with the governance in the public sector banks?

Dr. Chakraborty posed the question and answered: "I reiterate that the reason for NPA is non-performing administration. In the case of infrastructure, this could also be on account of non-performance beyond that of the bank management – that of policy makers, bureaucracy, etc."

Is WLTF similar to a development bank?

WLTF does not in many ways reflect the characteristics of a Development Bank. WLTF is basically a type of financial institution that is entirely market based with regulation tailored to the needs of long-term investments.

Is WLTF a solution to the problem of infrastructure financing or solution to the problem of non-performing assets in the banking system? Potentially, it could reduce the burden of financing on universal banks thus releasing resources for Working Capital advances. It could help the new institution build expertise in infra-financing.

Is it desirable to have WLTF as a category of banks with regulatory relaxations or would it be better to have a category of non-banking financial companies with appropriate regulatory framework? This is a choice that has to be made recognising that special regulatory prescriptions have already been given to banks in regard to infrastructure funding.

The hope is that a specialised private sector bank with appropriate regulatory framework could work better. However, experience shows that support of government in some form or other is critical for infrastructure development. How do we ensure that? IDFC was actually an experiment in financial support for private sector infra-financing, which has not survived for long.

There are several other questions for which answers require some probing and analysis.

What were the reasons for the IDFC which was founded and financed by the Government getting transformed into a private sector bank? Does it provide lessons for the future of a development bank for infrastructure?

What has been the experience of IIFCL a 100 per cent Government owned institution in funding the infrastructure?

Should the RBI revive financing of Development Banks at concessional rates of interest? How would it impact the government securities markets? What are the implications for monetary policy?

Is the assumption that development banking has been de-emphasised in India as part of the reform process backed by evidence?

Is there evidence to show that the performance of the existing Development Banks is inhibited by inadequate fiscal support? How do we reconcile the impressive profitability of the Development Banks with the distress in the sectors and activities that Development Banks are expected to finance?

Is it possible that the underlying problems relate to the savings investment balance and the claims of Government vis-a-vis the private sector over the household financial savings?

CONCLUSION

To conclude, the evidence of effectiveness of development banking in the Indian conditions is at best mixed. There is a crying need for understanding the real economy issues, the macro economic issues and the institutional capabilities in the current Indian situation before we proceed with prescribing development banking as a possible solution.

More important, the finance issues cannot be considered without reference to risks and rewards within and economic sector and institutional environment outside of it.

We, therefore, need to introspect and evaluate our experience before moving forward on Development Banking in a big way.

The immediate step should be for NITI Aayog to work on the future role of Development Banking in India.

There are, no doubt, serious problems in infrastructure funding and a beginning has to be made to address them with some initiatives to meet them. WLTF is a good way of starting the process irrespective of whether it is considered as a Development Bank or not, RBI should be encouraged to work expeditiously on this initiative.

Thank you.

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